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Person To Contact:

, ID No.

Telephone Number:

Refer Reply To:

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Date:

October 27, 2009

Legend

Trustor	=
Spouse	=
Trust	=
Corporate Trustee	=
Individual Co-Trustees	=
Son	=
GC1	=
GC2	=
GC3	=
GC4	=
GGC1	=
GGC2	=
GGC3	=
GGC4	=
GGC5	=
GGC6	=
GGC7	=
GGC8	=
GGC9	=
A	=
Court	=
Settlement Agreement	=
State	=
\$O	=

\$P	=
\$Q	=
\$R	=
\$S	=
Date 1	=
Date 2	=
Date 3	=
Date 4	=
Court Order 1	=
Court Order 2	=
Court Order 3	=
Cite 1	=
Cite 2	=
Cite 3	=

Dear :

This responds to your letter dated April 20, 2009 requesting rulings on the estate, gift, and generation-skipping transfer (GST) tax consequences of proposed modifications to a trust under a court-approved settlement agreement.

The facts submitted and the representations made are as follows. On Date 1, Trustor and Spouse created a revocable trust. On Date 2, Trustor died, and Trust was divided into a marital trust and a residuary trust. Spouse died on Date 3. The assets of marital trust passed to the residuary trust (Trust), which remains in existence and is the subject of this ruling. Dates 1, 2, and 3, occurred prior to September 25, 1985. Since its inception, the situs of Trust has been State.

Article Fourth, Paragraph G(2), of Trust provides that, after Spouse's death, Son and his non-adopted issue of whatever degree will be the beneficiaries of Trust until it terminates.

Article Fourth, Paragraph G(1), provides the trustee with the authority to pay, or apply for the benefit of, any beneficiary as much of the net income as the trustee deems necessary, in the trustee's discretion, for the reasonable care, support, maintenance, education and recreation of the beneficiary.

Article Sixth, Paragraph E, provides the trustee with the discretionary authority to distribute to, or for the benefit of, a beneficiary part, or all, of the principal of the trust as often as the trustee deems necessary.

Article First, Paragraph D, provides that the Corporate Trustee shall have the authority to make discretionary distributions of income under Article Fourth, Paragraph G(1), and discretionary distributions of principal under Article Sixth, Paragraph E.

Article Fourth, Paragraph G(3), provides that Trust will terminate upon the death of Son and when there is no child of Son who is under the age of 25 years. Paragraph G(3) also provides Son with power to appoint the Trust principal that remains undisposed upon termination. The power may only be exercised in such a manner as to distribute the trust estate outright. Furthermore, the power may be exercised only in favor of “any one or more of the group consisting of the issue of the Trustor,” Son’s issue, and the issue of Trustor’s deceased brother. If Son fails to exercise the power of appointment, the assets will be distributed to the living issue of Son upon the principle of representation. If Son dies leaving no living issue, the assets will be distributed to Trustor’s brother’s living issue upon the principle of representation. If no issue of Trustor’s brother is living when Trust terminates, the assets pass to Trustor’s legal heirs under the State intestacy law.

Article Fourth, Paragraph G(4), provides that unless Trust terminates at an earlier date under Paragraph G(3), it will terminate on the date that is twenty-one (21) years after the death of the last to die of the beneficiaries in being at the time Trust became irrevocable.

At the current time, Corporate Trustee, Son, and A serve as trustees of Trust. Son has 4 children who are the grandchildren of Trustor (GC1, GC2, GC3, and GC4), and 9 grandchildren who are the great grandchildren of Trustor (GGC1, GGC2, GGC3, GGC4, GGC5, GGC6, GGC7, GGC8, and GGC9).

The trustees became aware that Son’s power to appoint the Trust assets to the Trustor’s issue provides Son with a general power of appointment over the assets of Trust. Corporate Trustee petitioned Court for a judicial reformation of Article Fourth, Paragraph G(3). The trustees submitted documentation indicating that Trustor intended to provide Son with only a limited power of appointment.

Court subsequently issued Court Order 1 ruling that Trustor intended to grant Son a limited power of appointment over the Trust assets. Court Order 1 judicially construed and reformed the governing provision to add the following parenthetical so that the seventh sentence of Article Fourth, Paragraph G(3), reads, “The power may be exercised only in favor of any one or more of the group consisting of the issue of Trustor (except that such power may not be exercised in favor of [Son]), the issue of [Son] and the issue of the Trustor’s deceased brother. . . .” The judicial construction and reformation with respect to Son’s power of appointment relates back to the creation of Trust.

Corporate Trustee has consistently exercised its discretion to make annual distributions of income, and occasionally principal, to Son, GC1, GC2, GC3, and GC4. Corporate Trustee distributed larger amounts to Son and smaller equal amounts, to GC1, GC2, GC3, and GC4. In recent years, GGC1 and GGC2 requested discretionary distributions from Corporate Trustee. Son and GC1 disputed GGC1's and GGC2's status as beneficiaries of Trust. Corporate Trustee filed a petition for construction requesting that the Court determine the current beneficiaries of Trust. Court appointed a Guardian Ad Litem to represent GGC3, GGC4, GGC5, GGC6, GGC7, GGC8, GGC9 and unborn issue. Beneficiaries from each level were represented and participated in the litigation. During the litigation, other matters related to trust administration were disputed. The Court set the Petition for Construction and related issues for trial, allowing discovery and mediation to take place. After lengthy negotiations, including two mediations, the parties executed Settlement Agreement.

Pursuant to Paragraph 2 B of Settlement Agreement, the parties agreed that the beneficiaries of the trust are the non-adopted issue of Son living during the existence of Trust. Paragraph 2 C of Settlement Agreement replaces the discretionary distribution standard under Article Fourth, Paragraph G, and Article Sixth, Paragraph E, with fixed annual distributions of \$O to Son and \$P to each of GC1, GC2, GC3, and GC4. For the year(s) following the execution of Settlement agreement but preceding the issuance of a favorable ruling from the Service, the Corporate Trustee will distribute \$Q to Son and \$R to each of GC1, GC2, GC3, and GC4. Paragraph 2 C also provides that GGC1, GGC2, GGC3, GGC4, GGC5, GGC6, GGC7, GGC8, GGC9, and any additional beneficiaries at this generation level or lower are entitled to an annual sum of up to \$S for four years for certain educational expenses. Such lower level beneficiaries may also request discretionary disbursements for collegiate and post graduate educational assistance. Under Paragraph 2 E, Corporate Trustee may make discretionary distributions to assist any beneficiary with a medical emergency that is considered to be major and catastrophic and is not covered by insurance.

Paragraph 2 C 5 of Settlement Agreement provides that upon termination, the trust corpus will be distributed as directed in the written power of appointment Son executed on Date 4. If Son revokes such power prior to his death, Son will be considered to have waived the right to further exercise the power to appoint Trust assets and the corpus will be distributed pursuant to the governing terms of the instrument.

Paragraph 2 D of Settlement Agreement requires that the Individual Co-Trustees and the Corporate Trustee annually agree on the portfolio management decisions.

In Court Orders 2 and 3, the Court approved the terms of Settlement Agreement and construed the beneficiaries of Trust as those determined in Paragraph 2 B, conditioned upon a favorable ruling by the Service that Settlement Agreement will not subject Trust to the GST tax.

Trust was irrevocable on September 25, 1985, and Corporate Trustee represents that there have been no additions to the trust after September 25, 1985.

Rulings Requested:

1. Under Court Order 1, (1) Son does not possess and has never possessed a general power of appointment with respect to Trust that would cause the corpus to be includible in his gross estate for federal estate tax purposes, (2) Son will not be treated as having released a general power of appointment for federal tax purposes under §§ 2514(e) or 2041(b)(2), and (3) neither Trust nor distributions therefrom will be subject to the provisions of chapter 13 of the Internal Revenue Code of 1986 (Code).

2. Court Orders 2 and 3 and Paragraph 2 B of Settlement Agreement construing and interpreting the terms of Trust to define the beneficiaries of Trust to include each of the non-adopted issue of Son who are living during the existence of Trust will not cause Trust, or the resulting distributions made from Trust, to become subject to the provisions of chapter 13 of the Code.

3. The modification of the distributive terms of the governing instrument as enumerated in the Settlement Agreement in Paragraphs 2 C and 2 E will not cause Trust, or the resulting distributions made from Trust, to become subject to the provisions of chapter 13 of the Code.

4. Paragraph 2 C 5 of the Settlement Agreement, which modifies the terms of the governing instrument related to the distribution of Trust assets on termination and the power of appointment exercisable by Son, will not cause Trust, or the resulting distributions made from Trust on termination, to become subject to the provisions of chapter 13 of the Code.

Ruling 1:

Section 2001(a) provides that a tax is imposed on the transfer of the taxable estate of every decedent who is a citizen or resident of the United States.

Section 2041(a)(2) provides that the value of the gross estate includes the value of property to the extent of any property with respect to which the decedent has at the time of death a general power of appointment, or with respect to which the decedent has at any time exercised or released the power of appointment by a disposition which is of the nature that if it were a transfer of property owned by the decedent, the property would be includible in the decedent's estate under §§ 2035 to 2038 inclusive.

Section 2041(b)(1) provides that the term "general power of appointment" means a power exercisable in favor of the decedent, the decedent's estate, the decedent's creditors, or the creditors of the decedent's estate.

Section 2041(b)(2) provides that the lapse of a general power of appointment during the life of the individual possessing the power shall be considered a release of the power.

Section 2501 imposes a tax on the transfer of property by gift.

Section 2511 provides that the gift tax shall apply whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible.

Section 2514(b) provides that the exercise or release of a general power of appointment shall be deemed a transfer of property by the individual possessing the power. Section 2514(e) provides that the lapse of a general power of appointment during the life of the individual possessing the power shall be considered a release of the power. Section 2514(c) provides that the term “general power of appointment” means a power that is exercisable in favor of the individual possessing the power, his estate, his creditors, or the creditors of his estate.

Section 2601 imposes a tax on every GST. A GST is defined under § 2611(a) as: (1) a taxable distribution; (2) a taxable termination; and (3) a direct skip.

Section 2612(a)(1) defines the term “taxable termination” as the termination (by death, lapse of time, release of power, or otherwise) of an interest in property held in a trust unless – (A) immediately after the termination, a non-skip person has an interest in the property, or (B) at no time after the termination may a distribution (including distributions on termination) be made from the trust to a skip person. Section 2612(b) defines the term “taxable distribution” as any distribution from a trust to a skip person (other than a taxable termination or a direct skip). Section 2612(c)(1) defines the term “direct skip” as a transfer subject to the federal estate and gift tax of an interest in property to a skip person.

Section 2613(a) provides that the term “skip person” means (1) a natural person assigned to a generation which is 2 or more generations below the generation assignment of the transferor, or (2) a trust in which all interests are held by skip persons, or (3) a trust where no trust distributions, including those upon termination, may be made to a non-skip person.

Section 26.2601-1(a)(1) of the Generation-Skipping Transfer Tax Regulations provides that except as otherwise provided in § 26.2601-1(a), the provisions of chapter 13 of the Code apply to any generation-skipping transfer made after October 22, 1986.

Under § 1433(b)(2)(A) of the Tax Reform Act of 1986 and § 26.2601-1(b)(1)(i), the GST tax provisions do not apply to any GST trust (as defined in § 2652(b)) that was irrevocable on September 25, 1985, but only to the extent that the transfer is not made

out of corpus added to the trust after September 25, 1985 (or out of income attributable to corpus so added).

Section 26.2601-1(b)(1)(iv) provides that if an addition is made after September 25, 1985, to an irrevocable trust which is excluded from chapter 13 by § 26.2601-1(b)(1), a pro rata portion of subsequent distributions from (and terminations of interests in property held in) the trust is subject to the provisions of chapter 13.

Section 26.2601-1(b)(4) provides rules for determining when a modification, judicial construction, settlement agreement, or trustee action with respect to a trust that is exempt from the generation-skipping transfer tax under § 26.2601-1(b)(1), (b)(2), or (b)(3) will not cause the trust to lose its exempt status. The rules of § 26.2601-1(b)(4) are applicable only for purposes of determining whether an exempt trust retains its exempt status for generation-skipping transfer tax purposes. They do not apply in determining, for example, whether the transaction results in a gift subject to gift tax, or may cause the trust to be included in the gross estate of a beneficiary, or may result in the realization of capital gain for purposes of § 1001 of the Code.

Section 26.2601-1(b)(4)(i)(C) provides that a judicial construction of a governing instrument to resolve an ambiguity in the terms of the instrument or to correct a scrivener's error will not cause an exempt trust to be subject to the GST provisions if: (1) the judicial action involves a bona fide issue; and (2) the construction is consistent with applicable state law that would be applied by the highest court of the state.

In Commissioner v. Estate of Bosch, 387 U.S. 456 (1967), the Court considered whether a state trial court's characterization of property rights conclusively binds a federal court or agency in a federal estate tax controversy. The Court concluded that the decision of a state trial court as to an underlying issue of state law should not be controlling when applied to a federal statute. Rather, the highest court of the state is the best authority on the underlying substantive rule of state law to be applied in the federal matter. If there is no decision by that court, then the federal authority must apply what it finds to be state law after giving "proper regard" to the state trial court's determination and to relevant rulings of other courts of the state. In this respect, the federal agency may be said, in effect, to be sitting as a state court.

State law provides that the courts are vested with the authority to reform a trust instrument and that to the extent a word or phrase of importance is omitted by mistake, it may be added in through the judicial power of reformation if the instrument contains the means of doing so with certainty. Cite 1; Cite 2. Judicial reformation of a trust to conform to the intent of the settlor at the time of execution will relate back to the date that the instrument was executed. Cite 3.

In this case, the documents submitted indicate that Trustor intended to provide Son with only a limited power of appointment in Article Fourth, Paragraph G(3). Based on the

facts submitted and the representations made, we conclude that the judicial action involves a bona fide issue. Court Order 1 reformed Article Fourth, Paragraph G(3), to correct a scrivener's error. The order is consistent with applicable state law that would be applied by the highest court of State.

Accordingly, we conclude that: (1) Son's power of appointment, as judicially modified, is not a general power of appointment for purposes of § 2041; (2) the judicial modification of Son's power of appointment is not an exercise or release of a general power of appointment that would result in a taxable gift under § 2514 or would result in inclusion in his gross estate under § 2041(b)(2), and (3) the reformation will not cause Trust to lose its exempt status for purposes of the GST tax under § 2601.

Rulings 2 – 4:

Section 26.2601-1(b)(4)(i)(B) provides that a court-approved settlement of a bona fide controversy regarding the administration of the trust or the construction of terms of the governing instrument will not cause an exempt trust to be subject to the provisions of chapter 13, if – (1) the settlement is the product of arm's length negotiations, and (2) the settlement is within the range of reasonable outcomes under the governing instrument and applicable state law addressing the issues resolved by the settlement. The regulations further provide that a settlement that results in a compromise between the positions of the litigating parties and reflects the parties' assessments of the relative strengths of their positions is a settlement within the range of reasonable outcomes.

Section 26.2601-1(b)(4)(i)(D) provides that a modification will not cause an exempt trust to be subject to the GST tax if the modification does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation (as defined in section 2651) than the person or persons who held the beneficial interest prior to the modification, and the modification does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust. A modification of an exempt trust will result in a shift in a beneficial interest to a lower generation beneficiary if the modification can result in either an increase in the amount of a generation-skipping transfer or the creation of a new generation-skipping transfer. A modification that is administrative in nature that only indirectly increases the amount transferred (for example, by lowering administrative costs or income taxes) will not be considered to shift a beneficial interest in the trust.

Section 26.2601-1(b)(4)(i)(E), Example 3, considers a situation where, in 1980, Grantor established an irrevocable trust for the benefit of Grantor's children, A and B, and their issue. The trust is to terminate on the death of the last to die of A and B, at which time the principal is to be distributed to their issue. However, the provision governing the termination of the trust is ambiguous regarding whether the trust principal is to be distributed per stirpes, only to the children of A and B, or per capita among the children, grandchildren, and more remote issue of A and B. In 2002, the trustee filed a

construction suit with the appropriate local court to resolve the ambiguity. The court issues an order construing the instrument to provide for per capita distributions to the children, grandchildren, and more remote issue of A and B living at the time the trust terminates. The court's construction resolves a bona fide issue regarding the proper interpretation of the instrument and is consistent with applicable state law as it would be interpreted by the highest court of the state. Therefore, the trust will not be subject to the GST tax.

In this case, Trust was irrevocable on September 25, 1985, and the trustees have represented that there have been no additions to the trust after September 25, 1985. Son and GC1 disagreed that GGC1 and GGC2 were beneficiaries of Trust. Corporate Trustee petitioned Court to determine the beneficiaries of Trust. Court set the case for trial and ordered mediation, during which the beneficiaries disputed other trust administration issues. To avoid litigation, the parties executed Settlement Agreement determining the beneficiaries of the trust and resolving the other trust administration issues discussed during mediation. In Court Orders 2 and 3, Court construed the beneficiaries of Trust as those determined under Settlement Agreement, approved all of the terms of Settlement Agreement, and instructed the trustees to administer Trust in accordance with the terms of Settlement Agreement.

The trust document identified the beneficiaries as Son's non-adopted living issue of whatever degree, which Settlement Agreement construed as Son's non-adopted issue. Furthermore, under the terms of the trust instrument, Corporate Trustee had authority to make discretionary distributions of income and principal. Under Settlement Agreement, Corporate Trustee and the beneficiaries have agreed on the amount of distributions that will be made each year. Finally, under the trust instrument, Son has a limited power of appointment over the trust assets upon termination. Under Settlement Agreement, upon termination of Trust, Corporate Trustee will distribute the assets pursuant to the power of appointment Son executed on Date 4; provided, however, if Son revokes such power prior to his death, Son will be considered to have waived the right to further exercise the limited power of appointment and Corporate Trustee will distribute the assets according to the terms of the trust instrument.

Based on the facts presented and the representations made, we conclude that Settlement Agreement, including all terms and modifications thereunder, is the product of arm's length negotiation. Further, all of the terms of Settlement Agreement, as described above, present a compromise that reflects the parties' assessment of the relative strengths of their positions. Therefore, the agreement is within the range of reasonable outcomes under § 26.2601-1(b)(4)(i)(B)(2).

Moreover, the modifications to Trust under Settlement Agreement will not shift a beneficial interest in Trust to any beneficiary who occupies a lower generation (as defined in section 2651) than the person who held the beneficial interest prior to the modification, and they will not extend the time for vesting of any beneficial interest in the

trust beyond the period of 21 years after the death of the last to die of the beneficiaries in being at the time the trust became irrevocable.

Accordingly, we rule as follows:

1. Paragraph 2 B of Settlement Agreement, which concludes that the beneficiaries of Trust are defined as the non-adopted issue of Son who are living during the existence of Trust, will not cause Trust or its distributions to become subject to GST tax under § 2601.
2. The modification of the distributive terms of Trust as enumerated in Paragraphs 2 C and 2 E of Settlement Agreement will not cause Trust or distributions from Trust to be subject to GST tax under § 2601.
3. Modifications to the terms of Trust contained in Paragraph 2 C 5 of Settlement Agreement, which relate to the distribution of assets on termination and Son's power of appointment, will not cause Trust or distributions from Trust to be subject to GST tax under § 2601.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

This ruling is directed only to the taxpayers requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

The rulings contained in this letter are based upon information and representations submitted by the taxpayers and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,

James F. Hogan
Senior Technician Reviewer, Branch 4
(Passthroughs & Special Industries)

cc: